

BDAC Finance Work Group

Financial Principles Discussion Draft

Introduction

There has been considerable discussion of the purpose and utility of developing principles relative to the Financial Strategy for the CALFED Bay-Delta Program long-term Solution. All parties recognize that until the details of the programs and projects are available, including information on both costs and performance, no one is willing to commit to the details of any sort of Financial Strategy or cost allocation. When these details are available, parties will begin negotiation on the specifics.

Prior to commencing these negotiations, the Program believes that certain public policy principles should be established to define the parameters of the negotiated solution. These public policy principles should be constructed so as to be acceptable to potential negotiating parties, and specific enough to confine future discussions within ranges that parties have previously agreed to as reasonable.

Due to the programmatic nature of the Phase II process, full specific details on the complete list of programs and projects to be implemented will not be available at the time that a selection of the Preferred Alternative must be undertaken. Decision makers will be relying on this framework of public policy principles relating to Financial Strategy to help them understand the financial implications of their selection.

The draft Financial Case Study released in March 1997 included six general principles. These principles were discussed during the April 4 BDAC Finance Work Group meeting, at which time a number of suggestions were made for revised language. The following material is intended to further develop the concepts discussed at that meeting, in a continuing attempt to define the public policy framework for the Financial Strategy. Readers should refer to the Financial Case Study for discussion of the example alternative and Program s Solution Principles.

General Principles

1) Beneficiaries pay.

The thrust of the first principle is to recognize the concept that in general the beneficiaries of actions will pay for those actions. The Finance Work Group generally agrees with this principle, with the caveat that in cases where there is a clearly identifiable party responsible for causing a quantifiable portion of the problem, the identified party should pay their proportional share. In order to move this concept forward, it must be defined more clearly including implications for practical application of the concept.

The focus of most of the discussion on this principle relates to ecosystem restoration, specifically determining the degree to which users pay for ecosystem actions. This is difficult because although diversions have an impact on the ecosystem, it is not possible to say exactly how much of an impact relative to other factors.

Compounding this is the fact that it is difficult to place a dollar value on non-market ecosystem benefits. Certain methodologies exist to estimate such values, but results are not widely accepted and performing the related studies

BDAC Finance Work Group

Financial Principles Discussion Draft

is expensive and time-consuming. Flood control benefits have also been identified as difficult to quantify. What portion of the benefit of avoiding levee failure accrues to landowners as opposed to water diverters? Some have suggested the issue can be thought of as distinguishing between enhancement actions and mitigation actions. Beneficiaries would pay for enhancement, while responsible parties would pay for mitigation. This approach would require the definition of clear initial conditions, such that activities could be categorized as either within or exceeding the initial condition. Although the enhancement/mitigation concept might apply for specific localized problems, this concept may not work with the overall CALFED Bay-Delta Program because the focus is on what needs to be done: restoring the health of the ecosystem. No effort has been made to determine specifically who or what caused the problems leading to the decline of the health of the ecosystem, nor is it believed that such an effort could provide useful results.

Points to consider:

- (a) How should the benefits be quantified? Should we attempt to limit tools to things that can be measured without ambiguity? Dollar quantification is troublesome. Are there other means of quantification without ambiguity? Total water usage? Acreage? Others?

Suggested language:

Receipt of benefit can be used as an indication of potential obligation without using level of benefit as a means of determining financial obligation. Where level of benefit is used to determine obligation, a clearly quantifiable means of determining the level must be employed.

2) Comprehensive Approach

This principle is intended to treat the issue of recognizing parallel efforts and funding activities that contribute to CALFED Bay-Delta Program objectives. In the interim phase of the Program, the policy has been to consider only new or incremental funding for CALFED-related actions. Funding sources resulting from pre-existing programs or legal obligations has not been considered in discussions of matching contributions or incremental funding efforts.

For the long-term Program, however, this approach can change. Recognition of all funding contributions and programs that contribute to restoring the health of the ecosystem appears to be a more equitable approach.

The point was made that a separate principle may be implied relating to the policy of maximizing the number of different possible funding sources and participants. This suggests an attempt to identify and include all potential beneficiaries, even those that receive incidental benefit.

Points to consider:

- (a) What is the role and definition of the initial condition for the Financial Strategy? How does it relate to this principle of beneficiaries pay? What are the specific aspects of the initial condition that need to be defined?

BDAC Finance Work Group

Financial Principles Discussion Draft

Suggested language:

~~"Baseline"~~ or spending on Bay-Delta ecosystem restoration means funding provided or requested under authorities or obligation prior to the signing of the Delta Accord on December 15, 1994

- (b) Is it appropriate to consider only new sources during the interim, and transition to considering ongoing payments relative to pre-existing obligation for the long-term Solution? What rules should be used to define what ongoing payments are appropriate for consideration? For example, how should local payments toward local projects be considered?

Suggested language:

The Financial Strategy should include specific criteria or a process for considering local payments as financial contribution to the long-term Solution.

- (a) Should we attempt to include indirect beneficiaries as financial participants, or should inclusion be limited to direct beneficiaries?

Suggested language:

The Financial Strategy should identify as many potential funding sources as possible, including payments from indirect or incidental beneficiaries.

3) Funding Coordination

This principle is intended to provide guidance to the assurances process when they are designing the institutional structure for the Bay Delta solution. The implementing entity will have greater financial strength (leading to lower borrowing costs) and more financial efficiency and flexibility if funding activities are highly coordinated or centralized.

Suggested language:

The Financial Strategy should emphasize a high level of coordinating funding sources to provide for maximum financial strength, efficiency, and flexibility.

4) Economic Incentives

This principle is intended to focus the approach of the implementation on using economic incentives where feasible. Incentives are perceived to have several benefits over regulatory approaches, including greater individual freedom to determine appropriate actions, lower cost of achieving goals by concentrating actions in the most efficient areas, and providing continuing incentive to improve results even after achieving initial goals. Economic incentives imply market-based price signals rather than regulations, although incentives can include direct financial incentives from implementing agencies as a proxy for market price signals.

Within this principle is the concept that resource users will respond to the price signals they see as individuals. In order for incentives to be effective, the price signals users see must induce them to respond in the desired manner. Economists argue that ideally, price signals should accurately reflect the total costs of the resource use, including ecosystem effects. Historically, incentives have been established that have encouraged existing resource use patterns through price signals for resource use.

BDAC Finance Work Group

Financial Principles Discussion Draft

Suggested language:

The Financial Strategy should employ economic incentives where : order to encourage reaching goals in the most efficient and low- to create lasting incentives for improved performance, and to en choice and innovation in determining appropriate response to Pro initiatives.

5) Dynamic Cost Allocation

Many aspects of the long-term Solution will be subject to adaptive management. This means that although the objectives of the Programs will remain consistent over time, the roster of programs and actions may be modified in order to best achieve those objectives. This could result in different patterns and amounts of expenditures for portions of the long-term Solution.

The issue is whether or not this factor needs to be built into the initial cost design, or whether any need for such future changes should be dealt with when and if they occur. A completely different approach is to stipulate that the budget is fixed, regardless of the actions that may be undertaken to address the objectives.

The Assurances Work Group is addressing this issue in the context of providing financial resources for the ecosystem restoration program. One approach is to look at the issue in terms of a trade-off between upfront payments and future financial risk. The more dollars that are committed in advance, the greater is the protection from any future cost increases that is provided.

Suggested language:

The Financial Strategy should recognize the dynamic nature of a management program, and allow for periodic consideration of cha structures over time.